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TREASURY FOR FTAT, OCC/SIEGEL, AND OASIA/ICB/MAIER
TREASURY PASS TO FEDERAL RESERVE AND SEC/E. JACOBS

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TAGS: EFIN AU
SUBJECT: Austrian Bank Exposure to Central/Eastern/ Southeastern Europe

REF: A) VIENNA 484 and previous; B) VIENNA 451; C) 08 VIENNA 1619

Sensitive but unclassified: Protect accordingly.

¶1. (SBU) SUMMARY: Alarm over Austrian bank exposure to Central, Eastern and Southeastern Europe (CESEE) has given way to a more realistic view of the situation as difficult but manageable. Top Austrian banks will suffer losses in the region -- but they continue to make profits, have ramped up loan loss provisions, are taking advantage of GoA state aid, and appear sufficiently capitalized. Of Austrian bank assets in CESEE, 75% are in EU member states (countries unlikely to default outright) and very little of that portion is in the crisis-stricken Baltics. Still, Austrian banks cannot earn enough in the medium-term to fully cover expected loan losses, meaning that they could burn enough equity to trigger a second tranche of state equity injections -- which would not seriously endanger Austria's credit-worthiness, but might trigger EU conditionality, compelling Austrian banks to divest some foreign assets. END SUMMARY.

Realism is Supplanting Alarm over CESEE Exposure
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¶2. (U) Stock and bond market worries over Austrian bank exposure in CESEE -- which peaked in mid-March along with Hungarian payment difficulties, then briefly spiked again after negative remarks by Paul Krugman on April 13 -- have died down, as reflected in narrowing spreads for Austrian sovereign debt and in positive stock price developments for listed Austrian banks (Erste and Raiffeisen International). Markets no longer see Austrian banks as potentially sparking an Iceland-style default; rather the situation is viewed as difficult but manageable.

¶3. (U) In a June 26 press conference, OeNB Governor Ewald Nowotny said the "CESEE hysteria" is over -- reflected in lower risk premia for GoA debt, now back under 100 basis points -- and denies there is a region-wide "CESEE problem" for Austrian banks. Nowotny points out that loan assets in the Czech Republic are healthier than many assets in Austria, the UK, or Spain; acute problems are centered in a handful of countries such as Ukraine and the Baltics. Austrian banks spread their assets across the CESEE, and that 75% of their CESEE assets are in EU member states -- Slovakia and Slovenia are even in the Eurozone -- and Austrians have little exposure to the Baltic states. Most Austrian loan assets in the region are commercial/retail and not sovereign.

Banks' Situation in 2008 and Q1/2009
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¶4. (SBU) Most major Austrian banks earned positive profits in 2008 and again in Q1/2009. Despite that, they will not be able to earn enough money over the next few years to digest all loan losses to be expected, which means that they will burn some of their equity. Political sources suggest the OeNB estimates Austrian banks' medium-term losses in CESEE at EUR 50 Billion, more than a sixth of Austrian exposure in those countries. Privately, many observers

here expect that CESEE losses and loan losses in Austria -- where the credit default rate among private households is HIGHER than in CESEE, and where Austrian banks have considerably more at stake -- will eventually erode core capital of Austrian banks, requiring additional state capital injections under the current bank rescue package or beyond. These would NOT, however, endanger the long-term survival of key Austrian banks under current scenarios.

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A Second Round of Bank Support in 2010?
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¶5. (SBU) So far, about EUR 6 billion of Austria's EUR 15 billion set aside for state equity participation in banks has been disbursed (banks have also raised private capital since mid-2008). Assuming GoA negotiations with Bank Austria, BAWAG-PSK and Kommunalkredit bank are successful, another EUR 4 billion will be disbursed, leaving EUR 5 billion for future injections. The GoA has already obtained EU Commission approval for a 6-month extension of the current package through the end of 2009.

¶6. (SBU) MinFin experts still hold that the current bank rescue package (reftels) will suffice -- but analysts draw a mixed picture. Banking contacts say:
-- Italian-owned Bank Austria/BA looks well set
-- Erste Bank/EB may eventually need more equity, but would likely raise it on the capital market or look for a partner rather than resorting another state equity tranche
-- three other leading Austrian banks will likely will need additional GoA equity: Raiffeisen Zentralbank/RZB (and its consolidated CESEE/FSU subsidiary Raiffeisen International/RI), Volksbanken/VB, and BAWAG-PSK.

-- German-owned Hypo Alpe Adria/HAA is a special case and information on it is scarce.
That scenario could force the GoA to raise both the current EUR 3 billion ceiling per bank and its overall allocation of EUR 15 billion. However, FinMin contacts say the EU might force Austrian banks who get additional state capital to divest themselves of some foreign holdings to negate any "unfair" advantage from state help.

¶7. (U) RZB's June 2009 CEE Banking Sector Report ranks major banks active in CESEE by non-performing loans (as a share of total loans -- Austrian banks highlighted)
 ** HAA 7.8%
    Swedbank 7.3%
    VTB 7.0%
    OTP 5.7%
 ** RI 4.8%
 ** EB 4.8%
    Societe Generale 4.0%
    Intesa Sanpaolo 3.5%
 ** UniCredit 3.3% (including Bank Austria, but excluding Ukraine assets)
    NBG 3.3%
    EFG Eurobank 3.0%
 ** VB 2.8%
    KBC 2.5%
    Alphabank 2.4%
    Sberbank 2.4%.
RZB has also studied Q1/2009 profitability of CESEE subsidiaries:
-- UniCredit's CESEE subsidiaries (including those operated by BA) are all profitable
-- EB's subsidiaries are all profitable, except in Ukraine
-- RI's subsidiaries are all profitable, except those in Ukraine and Slovakia
-- VB's subsidiaries in Croatia and Serbia are profitable (no information available on other countries)
-- HAA's subsidiaries in Croatia and Serbia are profitable (no information available on other countries).

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AUSTRIA CESEE OVERVIEW -- BY BANK
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The following is a overview of Austrian banks with noteworthy CESEE holdings.

Bank Austria/BA
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¶6. (U) BA's consolidated net profit of EUR 1.1 billion in 2008 was only half of the 2007 result, because of revaluation on equity investments and impairment losses of EUR 1 billion on goodwill related to banks in CESEE. In Q1/2009, BA reported a profit of EUR 500 million (+35% from Q1/2008). In 2008, BA doubled its provisioning for loan losses to EUR 1 billion; provisioning in Q1/2009 reached 446 million (+157% from Q1/2008). BA's Tier 1 capital ratio was 6.82% at the end of 2008 and 6.95% in Q1/2009. BA is still negotiating with the GoA for an equity injection (ref A). Of BA's total business, 43% is in Austria and 57% in CESEE -- most of that in Russia, Croatia, Czech Republic, Hungary, Bulgaria, and Kazakhstan. BA's Ukraine exposure in 2008 was EUR 4.5 billion and in Kazakhstan EUR 6.1 billion. Baltics exposure is small.

Erste Bank/EB
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¶7. (U) Erste's 2008 consolidated profit was EUR 860 million (down 27% from 2007, because of the full write-down of intangibles in Ukraine and Serbia and a partial write-down of goodwill in Romania) and EUR 232 million in Q1/2009 (-26% from Q1/2008). All EB subsidiaries in the region (except Ukraine) were profitable in 2008 and again in Q1/2009. In 2008, EB set aside loan loss provisions of EUR 617 million (+136% from 2007), in Q1/2009 provisioning was EUR 370 million (up 127% from Q1/2008). Its Tier 1 capital ratio was 7.21% at the end of 2008 and 7.8% in Q1/2009. The subsequent issuing of non-voting participation certificates to private and institutional investors and the GoA equity of EUR 1.9 billion are expected to further increase Erste's Tier-1 ratio to about 9.8%. 35% of EB's CESEE exposure is in the Czech Republic (13% of total exposure) followed by Romania, Slovakia, Hungary and Croatia. EB has less than EUR 1 billion in Ukraine and no business in the Baltics.

Raiffeisen International/RI
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¶8. (U) RI's 2008 consolidated profit was EUR 982 million (+17% from 2007 and a new record) and EUR 56 million in Q1/2009 (-78% from Q1/2008). In reaction to the crisis, RI more than doubled new loan

loss provisions in 2008 (EUR 780 million), in Q1/2009 new provisioning was EUR 445 million (up 379% versus Q1/2008). Its Tier 1 capital ratio was 8.1% at the end of 2008, falling to 7.7% in Q1/2009. Early in the second quarter, RI parent Raiffeisen Zentralbank (RZB), signed an agreement for EUR 1.75 billion in GoA equity. RZB will devote part of that new equity to increase RI's Tier 1 ratio for Q2/2009. RI has 18% of its business in Russia, 13% in Slovakia, Hungary 11%, Czech Republic 9%, Poland and Romania 8% each, Croatia and Ukraine 7% each, Bulgaria 6%, and 13% in other CESEE markets. RI's 2008 balance sheet in Ukraine was EUR 6.3 billion; it has no Baltic exposure.

Volksbanken/VB
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¶9. (U) VB had an extremely difficult year in 2008. The collapse of its subsidiary Kommunalkredit (ref C) and investments with Lehman Brothers, Icelandic banks and in structured products led to losses of EUR 152 million in 2008 (versus a profit of EUR 220 million in 2007) and EUR 86 million in Q1/2009 (versus net profit of EUR 63 million in Q1/2008). VB increased its risk provisions by 61% to EUR 155 million in 2008, in Q1/2009 new provisioning was EUR 115 million (up almost 240% Q1/2008). VB's Tier 1 capital ratio was 7.6% for end-2008 and 7.4% in Q1/2009. VB is active in Bosnia-Herzegovina, Croatia, Czech Republic, Hungary, Romania, Serbia, Slovakia, Slovenia and Ukraine.

Hypo Alpe Adria/HAA

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¶10. (SBU) Scandal and mis-management have marked HAA for years, and in 2008 it reported a steep loss of EUR 520 million (after breaking even in 2007). The loss reportedly stemmed from problems with its majority shareholder, Bayerische Landesbank, and losses from derivatives, hedging, structured credits and other financial investments as well as Lehman Brothers and Iceland. In 2008, HAA almost doubled new risk provisions to EUR 533 million. With the GoA's equity participation capital of EUR 900 million and additional EUR 700 million in fresh equity from its shareholders, HAA was able to show a Tier 1 capital ratio of 8.3 % in December 2008 (Q1/2009 figures are not available). HAA is heavily engaged in the Balkans: of its total assets, only 46% are in Austria and 12% in Italy, versus 16% in Croatia, 11% in Slovenia, 6% in Bosnia-Herzegovina, 4% in Serbia and 5% in other countries. COMMENT: with a recent "E-Plus" rating from Moody's, HAA's future is very unclear. The bank is in restructuring, but Bayerische Landesbank is considering selling it or even outsourcing it into a "bad" bank. Of all major Western banks active in CESEE, HAA has the highest non-performing loan share (7.80% of total loans -- see para 7 above).

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CONCLUSIONS
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¶11. (SBU) Austrian banks active in CESEE -- with the exception of German-owned Hypo Alpe Adria/HAA -- seem basically sound, have sufficient equity, can still rely on good earnings, and largely escaped exposure to other toxic asset categories such as collateralized U.S. private debt. Even if several large Austrian banks need additional state capital (say, in 2010), none appears threatened with insolvency, nor would such help make the Austrian state incapable of servicing public debt.

¶12. (SBU) Market worries over Austrian bank exposure to CESEE seems to have peaked in early March, then calmed following:
-- IMF and EU pledges of support, particularly in the lead-up to the April 2 G-20 summit in London and
-- Austrian banks' upbeat results for 2008 and Q1/2009.
Market confidence is also bolstered by the strong commitment of Austrian banks to stay in the major CESEE markets -- i.e. they are adamant there will be no "race for the exits" unlike in Asia (1997) or Russia (1998).

¶13. (SBU) Septel will analyze the Austrian National Bank's just-released stress tests, which reinforce these conclusions.

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